THE CAPITAL STRUCTURE OF LARGE CORPORATIONS

AS AFFECTING

THE PUBLIC SHAREHOLDER AND INVESTOR

THESIS SUBMITTED

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Julian Eugene Little
(B. B. A.)
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INTRODUCTION

The interest of the public in large industry is growing, not only in dollars invested, but in numbers of persons holding the stocks and securities of our immense, and in many cases, unwieldy corporations. But with this diffusion of ownership, there has followed the loss of control by the actual owners, and worse, a loss of any means of knowing the financial condition of the company which is using their capital. Of course, the stockholder is usually, but not always, presented with statements purporting to set forth the "financial condition." Very little analysis is required of the average report to determine that it does not present the facts that the stockholder or investor have a right to know. The problem is stated by Lewis H. Haney: ". . . . for is not the house in which over three-fourths of our industry is carried on infested with disease? In a democratic country, hundreds of thousands of citizens in their economic relations are living in an oligarchy. Corporations, for the most part, have ceased to be 'little republics' in which the shareholder citizens govern through democratically elected representatives, and too often these shareholders are mere ignorant pawns in a game of high finance,--their shares the chips of a gigantic poker game. What is the trouble?"[1]

The reasons behind this misuse of the rights of the public stockholder are many and are closely interlocking. Back

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1. Business Organization and Combination, p. 375.

of the entire problem lies the fact that there are forty-eight sovereign states issuing charters under their individual laws. In many instances these laws are drawn for competitive purposes. Thus, with such "charter-mongering" states as Delaware, New Jersey, Maine, Arizona, and Nevada always trying to attract promoters, little wonder that corporations secure so much freedom and go beyond the control of ownership. We find, as a result of these laws, many kinds of stock with varying rights and privileges attached. There is par and no-par stock, participating and non-participating stock, common and preferred stock, voting and non-voting stock; each carrying with it some special privilege or lack of some inherent right of ownership.

The promoter has only to devise an idea and he has at his disposal states competing for the right to grant him a charter with any loop-hole he may desire for himself if the plan should not prove to be as profitable as his prospectus would indicate. "The vicious element in our natural life is contributed by the ingenious gentlemen who manufacture pretty printed certificates to take away from the people the prosperity they have earned."[2]

Corporations that are just coming into existance are not the only offenders; in fact, they are only a very small minority. Abuses of the public are found in old and well-established companies. Ownership's rights to dividends and of subscription to new issues of stock have been abused and forgotten. Proxies

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2. Hurdman, Frederick H.--Some Questions on No-Par-Value Stock. The Journal of Accountancy, January, 1925, p. 358.

are obtained to be used against the best interests of the voters who grant them. Owners who have only a minority interest have been treated much like "The Red-headed Step-child."

With the increasing distribution of the voting stock, a corporation can be controlled by an ever decreasing percentage of the outstanding shares. "It is a well known fact in American finance that, if the majority shares are scattered, a rather small minority of the stock held by an individual shareholder, or a little group of shareholders working together, can control the corporation almost as surely as if they held an absolute majority of all the stock outstanding."[3]

Published statements fail to convey the facts of the status of a company for any or all of several reasons. The New York Stock Exchange and other markets for stocks and securities have exerted a favorable influence on these reports by maintaining certain standards that must be met by all companies whose securities they list. Even then, the reports that are published have been known to vary materially from those presented to the exchanges. Perhaps this influence outweighs the fact that investors are often mislead by manipulations within these markets but how is the outsider to know that a rise or fall in a stock is due entirely to "corners," "short selling," and other inside manipulations? How can he determine, in the face of quoted prices, the actual value of his stock?

Statements are sometimes published with the view of

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3. Lyon, W. Hastings--Corporation Finance, p. 78.

discouraging and driving out minority interests. No stockholder wishes to hold stock in a company that continues to show a loss year after year. If he can be led to believe that his company is operating at a loss, when it has actually made enormous profits, the price of the stock can be forced abnormally low so that the "insiders" can purchase it far below its actual value.

Any seemingly innocent organization may be so heavily over-capitalized that it is almost impossible to earn profits large enough for a dividend on its common stock after interest is paid on bonds and mortgages and the preferred stockholders have been satisfied. This over-capitalization is due largely to the complaints of the public in the past that dividends were so large as to be out of proportion to interest on investment. The railroads offer the outstanding examples of over-capitalization because, rather than cut their rates in prosperous times, they issued more stock. Thereby, their profits were divided over more shares and caused less demand for lowering of rates since dividends were less per share. Now, in times of depression and with competition, they find it impossible to earn profits to pay a dividend equal to ordinary interest on the par value of their outstanding stock.

Watering stock has been a favorite method of the financier in securing subscriptions to new issues of stock and in publishing an optimistic report for the public, or to cover a deficit on the balance sheet. Various means are resorted to, most notable of which are: writing up good-will, over-valuing

fixed assets and inventories, failing to recognize adequate depreciation, and carrying valueless receivables with an inadequate reserve.

The management of the company, wishing to deceive the stockholder for their personal benefit, may, under the cloak of conservatism, fail to show the true status of the business. Large hidden reserves may be found in many organizations. This is accomplished, among other methods, by under-valuing fixed assets, carrying excessive reserves, omitting important assets, writing off good-will, and failing to show ownership in other companies.

Pyramiding by holding companies makes it most difficult to prepare a true statement even when the utmost care is taken and where there is no intention of misrepresentation. No consolidated statement can be analyzed intelligently without the statements of the sub-companies. Yet, seldom do we find a consolidated statement accompanied by statements of subsidiaries. Many times the percentage of ownership in subsidiaries is not disclosed.

The very nature of accounting makes it possible to show anything that is desired on a financial report, for accountancy can never be an exact science and all statements must be based, to some extent, on the judgment of the auditor or person responsible for their preparation. There is, at present, no necessity for a report to have any connection whatsoever with actual facts. It can be made to reflect anything that the management wishes the public to believe by the simplest of "book" entries.

Ownership and control have become so far separated that in relatively few cases does the person furnishing the capital for an enterprise have any voice in its management. The public even seems to have lost interest in its business but there has been nothing the people could do or learn, once they became stockholders. Their interest has been unwanted and it has been very expensive and required long periods in court for them to get any part of what is rightly theirs. "The holding of meetings in small towns, the suprise, the resentment with which corporate executives greet questions, and the policy of furnishing abbreviated, conundrum-like financial reports, discourage curiosity."[4]

The case of the purchase and reorganization of Dodge Brothers, Inc. in 1925 gives one of the outstanding examples of many of the abuses of the corporate stockholder and the investor.

> "And the feat of Dillon, Read & Co., the principal purchasers, in shifting their investment to the public within two weeks at a gross cash profit of $13,250,000, while retaining for themselves all the voting stock of the enterprise, can only be described as a startling piece of financial legerdemain-- . . . ."[5]
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> "Dillon, Read & Co. proceeded immediately to reincorporate the Company in Maryland (on April 8, 1925), and to sell to the investing public a sufficient volume of the new Corporation's securities to yield them a handsome immediate cash profit, while yet retaining full control of the enterprise. This they did in the following manner; they realized $74,250,000 in cash (gross, without deduction for marketing expense) from the sale of $75,000,000 of the Company's six per cent debenture bonds, which were offered at $99 and interest; they

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4. Weissman, Rudolph L.--Minority Stockholders. The American Mercury, May 1930, p. XXVIII.

5. Seltzer, Lawrence, H.--A Financial History of the American Automobile, p. 240.

realized $85,000,000 more in cash (gross) from the sale of 850,000 shares of no-par value, non-voting, preference stock bearing cumulative dividends of $7 a share, and 850,000 shares of no-par value, non-voting, Class A common stock, which were sold at the rate of one share of each for a joint price of $100; and they retained for themselves and their associates 650,000 shares of Class A common stock and the entire issue of 500,000 shares of Class B common stock, which latter class was given sole voting power in the Corporation. In other words, the investing public, which absorbed the offerings with surprising alacrity, paid $159,250,000 in cash for the bonds, preferred stock, and 56.67 per cent of the non-voting common stock of Dodge Brothers, Inc., while the promoters and underwriters compensated themselves with 57.5 per cent of the Corporation's entire common stock, including all of its voting stock.

"The prospectuses issued by Dillon, Read & Co. frankly declared that the preference and common stocks of the company were being issued ' almost entirely against the established earning power.' Under ordinary procedure, the balance-sheet of the Company would have reflected this fact by containing a large valuation for 'good-will' and other intangible assets; and such a treatment would have afforded a minimum of deception. Instead, however, the bankers took full advantage of the opportunities for disguise made possible by the legalization of 'no-par value' securities; and, as a result, they were able to present an initial balance-sheet for the Company that contained a valuation of only one dollar for intangible assets. This they effected by placing such arbitrarily low nominal values upon the Company's capital stocks as to reduce the total nominal capital liabilities to a figure consonant with the value of the net physical assets. In other words, instead of inflating property values by the insertion of a large 'good-will' item, they deflated the capital liabilities to only a fraction of their market value. Thus, the preference and Class A common stock sold to investors for $85,000,000 were carried on the books at a total value of only $935,000! The preference stock was given a book value of $1 a share; the two classes of common stock, 10 cents a share. Hence, while the asset side of the Dodge Brothers balance-sheet is innocent of the deception supposed to inhere in the inclusion of intangible items, the liability side is highly (though not technically) misrepresentative of the true state of affairs. Perhaps one reason for the adoption of this procedure was a desire to minimize the apparent quantity of securities obtained by the bankers for their promotion and under-

writing services: the 650,000 shares of Class A common stock and the 500,000 shares of Class B common stock that they received, constituting a clear majority of the entire common-stock issues, were given a total book value of $115,000."[6]

Published statements are used, as far as possible, as illustrative of the abuses of the stockholder and investor. In some cases it becomes necessary to construct hypothetical statements where no published statements are available for the purpose desired. These statements are not chosen in an attempt to make the picture any darker than is the actual case but are representative of what may, or may not, be found in any published report. These are the type of statement presented to the public--and they are received, in most part, without protest. "It has long been known, not only by Barnum but all the multitude of his successors, that the public will believe the label on the package in preference to a study of the contents. 'If it is in print it must be so' is a rule followed by countless numbers who would, no doubt, indignantly refuse to admit it."[7]

Many remedies have been suggested but few have been actually attempted. Cumulative voting has attained more popularity than any other remedy but it has come far from solving the problem. England has tried audits by stockholder interests with marked success. The answer in America seems to be a combination of several things. An adoption of the English practice, with additions, would undoubtedly help but with that should be

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6. Ibid., p. 242-4

7. Couchman, Charles B.--Juggling Corporate Capital. Nation's Business, November 1929, p. 45.

linked either a "Uniform Corporation Act" or, better still, a requirement for incorporation by Federal Statute. Nor then would the solution become entire without wholesome publicity and the interest of ownership.

It is not the purpose of this work to formulate laws as a solution to the problem, but rather to point out the defects of the present system, show its dangers, and indicate some remedies that would help to correct the evils. To draw up a code for chartering and controlling corporations is the work of a legal authority but there is an attempt to point out a few of the many things it should include.

The intention in making this study is not to discourage the stockholder but it is an attempt to call his attention to the abuse of his rights. It is hoped that it will assist in arousing interest that is necessary before any constructive work can be accomplished.

LAXITY OF STATE CHARTER LAWS.--Although New Jersey was the first state to recognize, to any significant extent, the advantages to be derived from the "wholesale" granting of corporation charters, others were not slow in following the lead. Delaware has now assumed the position of the most advantageous state in which to secure a charter, but close competition is found in Maine, Arizona, Nevada, West Virginia, and others.

"The business of issuing corporation charters to companies to ply their trade in any part of the country has attained mammoth proportions in Delaware, and it is a business that is impressive and peculiar in at least one particular; it is perhaps the only one in which a whole state, in its sovereign capacity, engages, with great profit to itself and to certain classes of its citizens, and with immense mortification and embarrassment, financial and spiritual, to its sister states."[1] It is said that in Dover there is an average of over one hundred stockholders meetings a day and that on a single floor of a moderate-sized office building in that city, there may be found the "home office" of some twelve hundred corporations.[2] " . . . . corporations by the thousand can be found cruising under the black flag of Delaware's corporation laws in search of easy money."[3] A. P. Richardson, in an editorial appearing in The

1. Flynn, John T.--Why Corporations leave Home. The Atlantic Monthly, September 1932, p. 268-9.

2. Ibid., p. 268.

3. Ibid., p. 270.

Journal of Accountancy, June 1929, says, "Such a law as that in Delaware purporting to govern the management of corporations seems to be almost wholly concerned with explaining what may be done in contravention of what should be done."[4]

Promoters from all parts of the country would not congregate in Delaware to secure charters if there were not special inducements offered to them. An analysis of these "advantages" shows almost all of them to be possible means of defrauding the public shareholder.

> "Almost anything goes in Delaware, and here are some of the things that go:
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> 1. Directors need not be stockholders. A collection of office boys would do just as well.
> 2. No officer or director need reside in the state. . . .
> 3. Directors meetings may be held outside the state, but stockholders must meet there. This is an important advantage to the promoters, for as a prospectus from Delaware puts it, if stockholders meetings were held in a populus place like New York, where so many stockholders would chance to live, a good many of them might attend the meetings, if only for curiosity. . . .
> 4. The directors may issue new stock and, indeed, affect the preference on old stock, without the approval of the stockholders. They may make by-laws without the approval of the stockholders. . . . .
> 5. Better than this, the right to elect all or a majority of the directors may be limited to one class of stockholders. . . . .
> 6. Stock may be issued, not only for cash, but for property, services, rights, and the product of one's brain; as an authority assures us. This may be called the waterworks department of the law. . . . .
> 7. Stock, of course, may be issued without par value. This provision becomes deadly when it is found provided that the no-par stock may be issued from time to time at such terms and prices as the

4. A Dangerous Development of Corporation Laws, p. 446.

directors may fix. They may issue a new batch of stock to the public at one price, to the stockholders at another, and to themselves at still another. It is within the power of the directors at any time, under this provision, to dilute the property of the stockholders, or, acting within the law, to rob them of their profits. This has actually been done on a large scale in countless instances.

8. The baleful system of issuing rights and stock purchase warrants, so generally abused before 1930, is permitted under the Delaware law. This is another method by which the directors and insiders are enabled to gamble with the corporation's money without taking any risk themselves. . . . .

9. Less than a majority of the board may constitute a quorum; in fact, provision may be made for alternate directors. . . .

10. In Delaware a corporation can be conjured into existence almost as fast as a magician can produce a bouquet of roses from his hat."[5]

In other state statutes are found similar provisions for chartering and governing corporations chartered under their laws. In Arizona, "Stock may be issued for money, property, or services. The fact that it may be issued for services may be an important advantage. Directors meetings may be held outside the state."[6] Connecticut laws provide for the following: "Stock may be paid for in either cash or property. The judgment of the directors is final with regard to the value of the property for which stock is issued, except in case of fraud. Incorporators may be non-resident. Corporations may hold stock in other corporations."[7] Maine offers inducements such as: "Stock may be issued for property, cash or services. The judgment of the directors is conclusive as to the value of the property--

5. Flynn, John T.--op. cit., p. 272-4.

6. Lough, William H.--Corporation Finance, p. 58.

7. Ibid., p. 58-9.

always provided there is no evidence of fraud. Incorporators and directors may be non-resident. Directors meetings may be held outside of the state. The corporation may acquire stock in other corporations."[8] Under the Nevada statutes: "Incorporators and directors may be non-resident. Stockholders and directors meetings may be held outside of the state. Stock may be issued for cash, property, or services. The judgment of the directors is conclusive as to value of property, provided there is no evidence of fraud. Action of the majority of the stockholders or directors may be valid without a regular meeting; that is, there may be an informal meeting held, without any notice whatsoever being given."[9] In New Jersey, which is perhaps Delaware's closest rival, we find that: "Corporations may hold stock in other corporations. Incorporators may be non-resident. Stock may be issued for property or cash. Judgment of the directors is conclusive as to value of property. (No mention of fraud). Directors meetings may be held outside of the state, if by-laws so provide. Cumulative voting is permitted. Voting trusts may be created."[10]

CAPITAL STOCK.--To facilitate the distribution of ownership of a corporation, its capital is divided into shares of stock. Each share represents a proportionate part of the ownership of the enterprise and all the shares, taken collectively,

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8. Ibid., p. 60.

9. Ibid., p. 61.

10. Ibid., p. 61.

are known as the capital stock of the corporation. Because these shares usually have a par value of $100, $50, $10, or some other arbitrary figure, it has become a common fallacy for the public to associate a share with a definite monetary value rather than to accept it as a certificate of ownership.

The two major divisions of capital stock are common and preferred. Each of these two types may be divided into several classes with many combinations of rights as to income and control, and of risk of investment. Common stock is ownership in the corporation representing an equity in the assets after satisfying securities with a prior lien. It carries no special privileges but may, if so specified, be deprived of inherent rights of ownership, such as voting. Preferred stock holds a preference over common stock in some one or more particular while, unless otherwise stated, it possesses the same rights and privileges that attach to common stock. Ordinarily, "preferred stock" means that this particular type of stock has a preference as to dividends; that is, that the holders of this stock must receive a specified rate on their holdings before any dividends may be paid on common stock. Unless otherwise provided, this dividend on preferred stock becomes cumulative. If the stated rate is not declared and paid in any year, it becomes a claim on future earnings which must be met before any dividend can be paid on common stock.

Preferred stock may or may not have a preference as to assets on disolution. If this preference is given, the

specified preference must be met before common stockholders are entitled to any share in the assets.

Non-participating preferred stock may be issued. This means that, under the terms of its issue, this class of stock receives no more than its specified rate--any balance going entirely to the holders of other classes of stock. Thus, if there are outstanding 1000 shares of non-participating, 6%, preferred stock of $100 par value and 1000 shares of common stock and there is a net profit of $50,000 for the period, all of which is declared in dividends, the preferred stockholders will receive $6000 while the common stockholders receive $44,000 or $44 per share.

In order to more easily maintain control of a corporation by holding a small percentage of its stock, non-voting stock may be issued. "All stockholders have the inherent right to participate in the management of the corporation through voting for directors and on other matters. Non-voting stock may be issued, however, and purchasers of such stock voluntarily surrender their voting rights. . . . The vote may be apportioned among several classes of stock in any desired manner as long as at least one class of stock is vested with voting power."[11] By this means, it has become possible to disfranchise great numbers of stockholders. The reorganization of Dodge Brothers, Inc. (see pages 6-8) offers an excellent example of the majority of the stock-

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11. Bonneville, Joseph Howard--Elements of Business Finance, p. 100.

holders having no voice in the management of their corporation.

There are instances where non-voting preferred stock is given the right to vote when dividends are in arrears for a certain period but this right comes rather too late to remedy evils that may have been the cause of failure to declare these dividends. It is much like the case of allowing a prisoner a new trial after he has served his sentence!

The advent of no-par stock in 1912 (New York) was heralded as a cure for all corporate abuses. It was, by erasing the dollar mark from a certificate of stock, to correct the misconception of the public that a share of stock represented its par value. It was to be the means of stopping over-capitalization and "stock-watering"; in fact, it was to be the "savior" of the shareholder. No doubt, the proper use of no-par stock would have proved most helpful but " . . . . No-par-stock law has been so bandied about that it has lost all its virtue."[12] It has not removed the idea of the monetary value of a share from the minds of the people; it has not stopped over-capitalization; nor has it kept down "watering." There has, instead, been opened a new and larger field for defrauding the stockholder. Frederick H. Hurdman says, "I do not believe that the use of no-par-value stock has served to eliminate or reduce the over-valuation of intangibles nor even served to warn the investing public against

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12. Richardson, A. P.--A Dangerous Development of Corporation Laws. The Journal of Accountancy, June 1929, p. 446.

the assumption of an arbitrary value for the stock."[13]

Since no monetary value is attached to no-par stock, it can be issued in any quantity as payment for property or services and there is no recourse to the courts as is the case when par-value stock is issued for assets. The value of capital stock outstanding can, for the same reason, be placed on the balance sheet at any figure the directors may desire. They may cover losses, and even leave an appearance of profits, though an actual loss was suffered for the period, by an adjusting entry between capital and surplus. Capital may be impaired by a dividend in excess of accumulated earnings. "In other words, if $100,000 is received by a corporation incorporated under the laws of Delaware in payment for capital stock of no-par value, and if it has no other class of stock, and the liabilities are, let us say, $10,000, the directors may determine that $90,000 of capital is no longer capital but is now surplus, and they may, if they deem it expedient or salutary, declare the full amount of $90,000 in the form of dividends to the stockholders."[14]

Shares may be sold at such a low figure as to encourage speculation and promoters may retain large blocks for promotion services (see pages 7-8). When stock may be sold at any price determined by the directors, the shareholders may find that their holdings have been materially reduced in value by the sale of a

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13. Some Questions on No-Par-Value Stock. The Journal of Accountancy, January 1925, p. 18.

14. Richardson, A. P.--op. cit., p. 445.

new issue at a price below its value. The directors may sell stock to the public for $100 per share and, a week later, sell similar stock to themselves at $1.00 per share!

No-par stock may permit the balance sheet to be grossly misleading. "The use of no-par value stock tends to permit the elimination from the balance sheet valuable information which we have been accustomed to expect in the statement of corporations."[15] Carl B. Robbins, in his book, "No-Par Stock," points out several methods, with comments on each, used in showing no-par stock on a balance sheet: (Stated capital $100,000, surplus $25,000)

> "No-par shares carried at the original issue prices:
> Net Worth:
> Capital stock, No-Par Value, 752 shares $75,000
> Surplus 50,000
> This statement is grossly misleading. . . .
> No-par shares carried at an arbitrary figure:
> Net Worth:
> Capital stock, No-Par Value, 750 shares $ 1
> Surplus 124,999
> Taken together these figures show that the net worth is $125,000, but separately they mean nothing. It is a plain case of concealment of the actual situation. Such figures cannot possibly be of use to anyone, unless, indeed, they are used by the corporation to deceive its creditors, its stockholders, and the public. . . .
> No-par shares carried at their book value:
> Net Worth:
> Capital Stock, No-Par Value, 750 shares $125,000
> (Surplus concealed)
> No-par shares carried at market value:
> Net Worth:
> Capital Stock, No-Par Value, 750 shares $137,500
> This method conceals the situation perfectly. It misleads corporate creditors to the maximum."[16]

RIGHTS OF SHAREHOLDERS.--With so many types of stock being issued, each of which may specify the divorce of the holder

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15. Stockwell, Herbert G.--How to Read a Financial Statement, p. 318.

16. P. 138-9.

from some right of ownership, one wonders if there remains any rights of the shareholder of some of our large corporations. But, unless otherwise specified, the stockholder has certain basic rights:

> "1. To proportionate ownership in the undivided assets of the corporation and to a certificate stating this ownership in shares.
> "2. To transfer ownership of his shares.
> "3. To receive dividends when earned and declared by the board of directors.
> "4. To inspect the corporate books.
> "5. To subscribe, in proportion to his holdings, to any new issue of stock.
> "6. To proportionate control through voting power.
> "7. To vote on other questions affecting the corporation property as a whole.
> "8. To protect the corporation against wrongful acts of a majority.
> "9. To restrain ultra vires acts of the corporation.
> "10. To share in the proceeds of dissolution."[17]

There is no question as to the first two of these rights for they seem to be the only ones which are not, in some instances, found missing. Although the right to transfer stock remains with the holder, the market may be so manipulated that it will be sold far from its true value.

Dividends, once declared, are a claim against the corporation but the declaration of dividends is left entirely to the judgment of the directors. There is no means, except perhaps by a lengthy and expensive process in court, of compelling any dividend whatsoever to be declared. "Whether the corporation fundamentally needs to be fed up, or whether it could with benefit

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17. Bonneville, Joseph Howard--op. cit., p. 90.

stand a little bloodletting through larger dividends are each matters for which the elected management must assume full responsibility; but it might well profit, and the shareholders certainly would do so, from an interchange of views upon the point."[18] The practice of withholding dividends may be used to encourage the sale of stock at a figure much below its value.

A stockholder is rarely allowed to inspect important books and records of his corporation. If he is permitted to review any of the books, they are usually of minor importance and little, if any, more is known than before they were inspected. Even with all the books before him, the average shareholder is not qualified to reach any reliable conclusions, nor does he have the time or inclination to make an adequate study. This is the work of a trained accountant and may require months with a staff of assistants.

The modern tendency is to permit sale of new issues of stock without giving present stockholders first option on their purchase. New issues are often brought on the market at a price which means a bonus to those who purchase the stock at this price. The holdings of old stockholders are decreased in value by an amount equal to this bonus. This abuse is often much more serious when stock is issued for property or services.

> "The pre-emptive right of old stockholders to subscribe pro rata to a new issue of shares does not hold in case the new shares are issued for properties or

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18. Ripley, William Z.--Main Street and Wall Street, p. 149.

in case the new issue is used as a bonus with other stocks or bonds. Thus an unscrupulous board of directors may connive with associates in swindle by issueing to such associates a block of stock in exchange for properties the market value of which is considerably less than the market value of the stock issued therefor. Such fraud is not precluded by the fact that most states require that no person may be a director of a corporation unless he be a stockholder of the corporation, for directors may be qualified legally by the possession of but a few shares. A few states have gone the extreme in this direction; the directors of a Delaware corporation, for example, need not be stockholders."[19]

No longer can it be said that a stockholder may exercise power by voting. The largest stockholder of either the United States Steel Corporation or the American Telephone & Telegraph Company owns less than 1% of the voting stock and John D. Rockefellow controls Standard Oil Company of Indiana with only 14.5% of its voting stock.[20] Many stockholders have too little interest to attend meetings to vote their stock while others, living at such a distance from the place where the meeting is held, cannot afford to attend. Anyone holding an interest in the company can, with some effort and expense on his part, secure proxies from a great many of these shareholders. By the use of these proxies (powers of attorney authorizing a person to vote the stock of another) control of a corporation may often be represented by only a small percentage of voting ownership. This practice is sometimes made worse by making proxies difficult to obtain (requiring notary seal) if few share votes are desired and

19. Robbins, Carl B.--No-Par Stock, p. 70.

20. Means, Gardiner C.--The Separation of Ownership and Control in American Industry. Quarterly Journal of Economics, November, 1931, p. 86.

making the process simple when many are desired.

Many instances, illustrating a variety of methods, may be found where the minority is "crushed" by majority interests. Accounts are juggled in every conceivable way and misleading reports are published almost daily in an effort to discourage and drive out small shareholders to the advantage of "insiders." Dividends are passed, profitable lines of the business are transferred to subsidiary companies, secret reserves are established and omissions are made on published statements. "Controversies arising in connection with the conflicting rights of different classes of shareholders illustrate the possibility of abuse of power by a strongly intrenched majority. Under existing corporation laws the rights of minority stockholders have too often been sacrificed."[21] Relief by court action invariably comes too late; the wrong may be corrected but the damage is seldom completely repaired. In cases where full damages are granted, the corporation, using stockholders' money, usually pays and there is no relief whatsoever for those who have disposed of their holdings.

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21. Ripley, William Z.--Railroads: Finance and Organization, p. 104.

PUBLISHED STATEMENTS

WHY THEY FAIL TO CONVEY FACTS

Only a glance at many statements, published for the purpose of informing stockholders as to the value of their holdings and the activities of their company, reveals them to be stinted and of little value for the purpose for which they supposedly were printed. This, it is explained, is necessary for competitive reasons.

> "One marvels at the audacity of corporations when they say that it is great injustice to them to compel display of their profits. The relation between state and corporation seems to have been forgotten. Is not the corporation a thing created by the state for the very reason that the corporation is an efficient producer? The state grant of permission to do business under the corporate form of organization with limited liability of participants is justified on no other grounds. The child seems to have bold mutiny in its heart when it complains of the operation of the only excuse for its creation and existence. And the parent is apparently intimidated by the child's self-asserted rights and authority."[1]

Scarcely ever can the average investor be expected to make an intelligent analysis of the material with which he is presented and in many instances the trained accountant can do no better than make a guess as to actual facts. Intentional omissions cannot be detected by the most experienced analyst and, where methods of valuation are not given, no one can form any absolutely reliable conclusions. Who can determine, from the statement, what is included under such headings as "Securities," "Investments," and "Miscellaneous Assets?" The reader has no

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1. Robbins, Carl B.--No-Par Stock, p. 117.

means of knowing that by being "conservative," the balance sheet is actually covering large secret reserves. Stockholders do not need "conservatism" or "shock absorbers for lean years"; they need the facts and they have a right to know these facts. Nor is there any means available to the stockholder and investor, who is desirous of obtaining facts about his corporation, other than these published reports. Even when no fraud is being practiced, such statements give reason for suspicion that all is not well and also leave an open door, at all times, for those who have access to the secrets.

As to the "Profit and Loss Statement" (at times entirely omitted from reports), the stockholder should know, at least, the net sales, the cost of production, operating and general expenses, selling expenses, maintenance cost, depreciation charges (how determined), and financial income and expenses. Although, with these facts, most stockholders may still be unable and unqualified to form reliable opinions, they may then take advantage of the judgment of competent experts who will be better able to determine actual earnings.

MANIPULATIONS IN STOCK MARKETS.--By requiring readable reports, the New York Stock Exchange and other stock markets have exerted a favorable influence on the published statements of corporations but it is not required that statements presented to the markets and those prepared for the public be identical or even similar. Nor are the stocks and securities of all corporations, whose stock is held publicly, listed on an organized

market. Thus, regulations passed by markets cannot be extended, by force of the market, to effect all stocks.

A recognized step in making a market for a new issue of stock is to so manipulate the price of the stock as to "gain the goodwill of speculators and brokers and arouse expectations of large profits."[2] When this is done skillfully and secretly, it is almost impossible for even the most experienced to ascertain that the price is a result of manipulation. How is the average investor to know that he is paying for a "trick of the market" rather than actual value?

An excellent example of manipulation of stock prices is found in the organization of the Oregon Railway and Navigation Company:

> "After the organization was complete, the visible assets of the Oregon Railway and Navigation Company did not exceed $3,500,000, while the total liabilities amounted to $21,000,000. . . . .
>
> "It will thus be seen that there were seven dollars of liabilities for every dollar of assets, and the intrinsic value of the stock was represented by a minus quantity of 20 per cent., having no positive value at all. In other words, it was 20 per cent. worse than nothing.
>
> "In spite of these facts, however, Mr. Villard had the stock listed at the Stock Exchange, and through a carefully prepared report, showing immense and unprecedented earnings, he had the stock bulled up to 200."[3]

With "short selling," "pooling," and other devices used by manipulators carrying the price of stocks far from actual value, the "outsider" buys and sells as desire or necessity commands.

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2. Lough, William H.--Corporation Finance, p. 254.

3. Clews, Henry--Fifty Years in Wall Street, p. 213.

Regardless of the value of the stock, if he buys, he must pay the quoted price; if he sells, he must accept the conjectual price of the market.

MINORITY INTERESTS.--In corporations making large profits, the majority may, for their personal interests, wish to acquire more of the outstanding stock. Since it is to their interest to secure additional stock at the lowest possible figure, various means are used to discourage minority interests and induce them to sell their holdings at a price much lower than actual value. In this sense, majority does not necessarily mean any group holding 51% of the outstanding stock or even of the voting stock outstanding but is interpreted as meaning any group holding control of the corporation, whether by proxy voting, from the mere fact that the stock is widely owned and not entirely voted, or because a particular type of stock is given the power to elect a majority of the directors.

Directors have the power to determine when and if dividends are to be declared and the amount of any such distribution. Value of stock is largely determined by the income it produces. If dividends are passed for several consecutive periods, the value of the stock to the investor becomes less for it is not producing an income. The majority may, through the directors, pass dividends and pile up large undistributed surpluses and thus acquire the stock of the minority at a very advantageous amount.

A subsidiary company may be brought into existence and owned largely by the majority of the original company. The profitable functions of the original company may be transferred to the

new corporation or contracts may be made whereby the subsidiary makes most of the profits.

Excessive salaries may, for a period, be paid to executives in order to reduce profits or majority holders may become executives and draw these exhorbitant salaries themselves. In the same connection, improvements may be made and charged to current expenses to reduce profits.

Where it is desirable to discourage the minority of a subsidiary, the holding company may demand payment of advances from the subsidiary at a time that will prevent it from declaring a dividend, due to its reduced cash position, although ample profits were earned.

Some few cases may be found where oppressive tactics on the minority are practiced openly but, to insure maximum effectiveness and reduce the possibility of court proceedings from the demands of the minority, the majority usually find it convenient to cover their actions and intentions by false or vague published statements. Even if they fail to deceive, they do not give evidence of what is being done.

FALSIFICATION IN ORGANIZATION.--The internal organization of many large corporations lends itself to the publication of statements that are vague, although not necessarily false. They may be over-capitalized, have large issues of watered stock, or have large secret reserves. The management may sponsor inadequate reports for various reasons, both for and against the interests of owners. The income tax laws have, in some instances, caused profits to be shown at as conservative a figure as possible,

while unduly large profits are shown in other cases to facilitate the sale of new issues of stocks. There may be a desire to write off goodwill in times of prosperity which, if actually existing, creates a secret reserve.

Whenever the actual value of the net assets (assets less liabilities) of a company decreases below its outstanding capital, the company is over-capitalized. Over-capitalization is closely related to stock-watering and unless bonds or stocks are sold at a discount (sale of stock at a discount is illegal), a new corporation cannot be over-capitalized unless there is stock-watering. A going concern may become over-capitalized by losses, either from operations or unusual misfortunes such as fire or storm losses, and from inadequate provision for depreciation of assets. The extent to which American corporations are over-capitalized may be seen by the number of stocks that continuously sell far below their par value on stock markets.

Railroads offer the outstanding examples of over-capitalization. Their managements find it impossible to pay reasonable dividends on present capitalization although they might be able to do so on original cost. This is largely the result of stock dividends and reorganizations of the roads at various times. Professor William Z. Ripley says, "Financial reorganization offers a fruitful field for an increase of capitalization irre-spective of assets, whether for railroads or industrial corporations. Occassionally a company succeeds in emerging therefrom with the same volume of outstanding securities with which it went into bankruptcy. By far the larger number come forth saddled

with heavier issues than ever before."[4]

A noteworthy example of industrial over-capitalization is found in the case of the incorporation of a small saw mill by its owners:

> "In many cases of capitalization a much larger number of shares of capital stock have been issued for property than the actual value of that property. In one case the owners of a saw mill worth $100,000 succumbing to the high-finance fever of 1901-1903, incorporated and issued to themselves $1,000,000 worth of full-paid capital stock in payment of the property; they took ten dollars of stock at par value for one dollar of property. They also sold a considerable portion of the stock at $100 per share before the accounts were examined and the inflated value discovered."[5]

"Stock-watering" is the increasing of the capitalization of a corporation without an equal increase in its assets. The amount of water in the stock of a corporation is the excess of the book value of its assets over the actual value of these assets. Professor Ripley lists seven occassions when stock-watering may occur: ". . . . in connection with construction; through replacement of property; by division of an accumulated surplus; as a concomitant of refunding; as an incident of consolidation; as a feature of financial reorganization; and, finally, in connection with the provision of new capital through issuance of shares or bonds."[6]

Stock-watering, as contrasted with over-capitalization, which may not be intentional, is intentional and, in most cases,

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4. Railroads: Finance and Organization, p. 259.

5. Stockwell, Herbert G.--How to Read a Financial Statement, p. 308.

6. Ripley, William Z.--op. cit., p. 232-3.

without defense. It is only a matter of writing up asset accounts to balance any issue of stock desired. In an attempt to earn dividends on the watered issues, prices may be raised and competition invited, with a waste of investment. The public is induced to purchase "gold bricks" and to pay enormous prices for stock that largely represents "water."

In 1910, General Motors issued common stock of a par value of $5,908,500 (besides $1,100,000 par value preferred stock and $112,450 in cash) for the practically worthless assets of the Heany Lamp Company. This issue of common stock was represented in 1928 by more than 2,381,000 shares of the Corporation's common stock ($25) with a market of more than $320,000,000.[7]

Another, but less fortunate, case of stock-watering is found in the organization of the Middle West Utility Company by Samuel Insull.[8] Insull organized the company, became president of the company, and sold to the company, stocks amounting to $330,000 which he owned in several small utility companies. For these stocks and a promise to pay $3,270,000, he received the entire issue of six million dollars of common stock and four million dollars of preferred stock. All the preferred and one million of the common stock was then sold to the public for $3,600,000 in order that the cash might be paid to the company. Insull retained control of the company with five million dollars of its common stock. The Middle West Utility Company then had

7. Seltzer, Lawrence H.--A Financial History of the American Automobile, p. 228.

8. Flynn, John T.--Up and Down with Sam Insull. Collier's, December 17, 1932, p. 21.

securities valued at $330,000 and cash of $3,270,000 but its outstanding capital was $10,000,000. The books could not balance--more assets were needed--so the securities were placed on the accounts at an "arbitrary" figure to make the difference. A mere "write up" of the assets of some six million dollars!

When the actual net worth of a company exceeds the net worth as shown on its balance sheet, a secret reserve exists. This may be accomplished in two ways: by understating assets or by overstating liabilities. The most common method of creating a secret reserve is by making excessive charges to depreciation of fixed assets. Other widely used methods are; writing down fixed asset values, allowing excessive reserves for bad debts and contingencies, under-valueing inventory, writing off existing and legitimate goodwill, and charging asset increases to current operating expenses. The Bank of England is said to own real estate with a value in excess of ten million dollars which is entirely excluded from its balance sheet.[9]

Such practices, in that they permit the showing of balanced profits and present means for covering unusual losses, are often hailed as praiseworthy and conservative. The fact is overlooked that unsuspecting stockholders may be led to sell their holdings at much less than value and that anyone knowing the secret may benefit thereby. For those who are informed, all that is necessary is to conceal profits and build up secret reserves for a period to drive down the price of the stock and

9. Walton Accounting Series--Advanced Accounting, Lecture 32, p. 1.

then purchase it in the market. The next step, of course, is to reveal these reserves. Surplus is thereby increased and the price of the stock rises and it is sold at a nice profit. The public is swindled but the entire transaction is within the sanction of the law! However, reserves, correctly used, are undoubtedly beneficial and are to be recommended but they should be plainly shown and explained on every report. If there is no ulterior motive, then why keep them secret?

The management may have various motives for publishing "window dressed" reports. The policy of the company may be known to only a few and, by the use of involved accounts, the unprivileged are left at a total loss.

> "Prior to the careful analysis of expense accounts, prescribed by the Interstate Commerce Commission, it was always possible to 'skin' a road, that is to say, to postpone the customary and in the long run necessary outlay for maintenance. Savings thus effected could be utilized for enlarged dividend disbursements. On the strength of this showing, the speculators could dispose of their holdings at a profit, and leave the road practically gutted."[10]

The management, having interests in another company, may promote the purchase of this company at a price much above value. Contracts may be made whereby the management is benefited or secret salaries or bonuses may be paid to officers and directors. Each of these encourages the use of involved accounts to conceal the facts from stockholders.

A certified public accountant made the following observation:

> "The methods employed for the purpose of giving a wrong impression to the stockholders or the public as to the company's condition as shown by the published

10. Ripley, William Z.--op. cit., p. 212.

balance sheet are almost innumerable, but I will cite a few.

"Where the accounts are subject to audit and it is desired to make a good appearance at the date of the balance sheet, the practice of borrowing a large sum of money from brokers or bankers for a few days is often resorted to. By this means, at the date of the balance sheet the company has apparently a large amount of available funds, though in point of fact the loan is repaid a few days later. In the same way, where such a corporation as a loan and investment company finds itself holding securities of a speculative character, such as mining stock, it is quite customary to make a sale of these securities to brokers a few days before the date of the balance sheet, with the understanding that the company is to repurchase them at the same price less commission for the accommodation a few days later. In this way the company avoids showing on its published balance sheet any investments that are not of gilt-edged character, and in both the instances quoted above it is very hard for the auditor to find any grounds for refusal to give an unqualified certificate to the balance sheet; the condition is as stated by the accounts at the particular date at which they are drawn up.

"Again, where it is desired to conceal from stockholders the fact that the company is making large profits or, on the other hand, incurring heavy losses, the valuation placed upon investments in stocks and bonds of other corporations or the valuation placed upon merchandise on hand is often juggled, the officers of the company constituting themselves the arbiters as to what is really the actual value of such assets.

"Another window-dressing plan often employed is to treat the balances due on current account from the branch houses of the corporation as though they were accounts receivable due from ordinary customers. Goods on consignment are often similarly treated as though they were accounts receivable and included in the balance sheet at sale price under this caption instead of at cost price."[11]

ACCOUNTING--ITS NATURE AND MISUSE.--Accounting is a prerequisite to large business. No business, except very small organizations, could exist for long without some system of accounts. Its value may be expressed by the difference between our mammoth business structures and practically no

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11. Lough, William H.--op. cit., p. 370-1.

business--the difference between large, nation-wide corporations and insignificant, one-man proprietorships. But, when used unethically, accounting becomes one of the most deadly weapons of industry. By improper entries, books of account and statements can be made to show anything that is desired or, as is often the case, nothing whatsoever. The public too generally holds the idea that "because it balances, it is correct." Even truth has many sides; a conservative view may be taken and the condition shown as unfavorably as possible, while an optimist will prepare a report which goes to the opposite extreme. The responsibility does not fall on accounting as a science but on those who are responsible for the preparation of the accounts.

Suppose a concern shows net earnings for a year of $8.00 per share of outstanding stock. This might be made up of actual profits of $1.00 per share, a write-up of fixed assets, inventories and goodwill of $4.00 per share, income from the sale of capital assets of $2.00 a share, and an increase in surplus from a reversing entry to some contingency account for $1.00 per share. Unless these facts are brought out in the report, the public is lead to believe that the company made normal profits for the period. On the other hand, suppose actual profits amounted to $20.00 per share on the outstanding stock but that the following took place. Goodwill amounting to $4.00 per share was written off against current income, reserve charges for depreciation and doubtful accounts were arbitrarily increased by $2.00 per share, asset values were reduced by an amount equal to $4.00 a share, and unnecessary reserves for contingencies were set up

equaling $2.00 per share. The financial statements again show a net profit for the period of $8.00 per share and the cry of the shareholders for dividends is not nearly so loud as if true profits had been shown. In the first supposition, the market for the stock would be held above its value and shareholders would, perhaps, receive a dividend representing, in part, a distribution of capital. In the second instance, the market price of the stock would, in most cases, be held below actual value while a reserve would be established to be drawn against in lean years. It is a simple trick of accounting--incorrect book entries!

HOLDING COMPANIES.--When any corporation holds the majority of the stock of one or more other companies it is known as a "holding company." It receives dividends from the sub-company and votes its stock at stockholders' meetings of the subsidiary for any advantage to the holding company. By repeating this process of sub-company ownership, known as "pyramiding," the parent company may secure control of numerous companies with little or no additional capital outlay on its own part. This is done as follows: Company A owns fifty-one per cent. of the stock of Company B which in turn owns fifty-one per cent. of the stock of Company C. Thus Company A controls Company C with actual ownership of only 25½% of its stock and no capital expenditure on its part. Each time the process is repeated, Company A secures control of another subsidiary but with each repetition the percentage of actual ownership required diminishes by one-half of that owned in the immediately preceeding

instance. By this method, control, as effective as that of sole ownership, can be had with ownership of a very small part of the outstanding stock of the company controlled.

Almost invariably the report published by a holding company contains only the consolidated statement of the parent corporation and in many cases the percentage of ownership in subsidiaries is not given. The public is left to guess whether there is fifty-one or one hundred per cent. ownership. Nor can a stockholder obtain all the information in which he is interested without the full statements of all subsidiaries. He cannot determine the liquidity of his company or the amount of surplus available for dividends.

The extent to which holding companies operate is demonstrated by the pyramiding in railroad companies. Nearly ninety percent of the railroad mileage of the United States is controlled by fifty-seven systems, the other ten per cent. being largely composed of short, unprofitable lines.[12]

SEPARATION OF OWNERSHIP FROM CONTROL.--The parting of ownership and control in our large corporations furnishes the background for publication of misleading and inadequate reports. Where the two are in conjunction, those interested in the facts concerning the business are able to obtain the information and, except for tax and credit purposes, there is no motive for presenting anything but facts in published reports. Although the moral obligation of corporate management to publish more informative reports increases as ownership becomes widely diffused,

12. Clews, Henry--op. cit., p. 1047.

that obligation becomes more and more neglected. As the voice of ownership becomes less effective, the stockholder comes to be looked upon as a necessary evil to be disposed of in the shortest manner possible rather than as an owner in the business. There is a conspicuous absence of information that will place him on a par with insiders concerning facts as to the company's financial operations and condition. As long as these conditions exist, we cannot hope to find a change in the status of the average published report--it will continue to be vague, inadequate, and misleading.

ILLUSTRATED STATEMENTS

EFFECT ON CAPITAL SET-UP

BALANCE SHEET.--No financial report can be properly interpreted without a correct balance sheet. It must be correct in nomenclature as well as in amounts in the money columns if it is to be really informative. To facilitate interpretation and comparisons, proper classification should be maintained. Several good forms have been published, most notable of which are those recommended by the Federal Reserve Board and the Interstate Commerce Commission, in an effort to promote clarity and uniformity in published statements but they have received very little usage by unregulated organizations. Too much is shown for them to be convenient for the use of many corporations. As a rule, a short, conundrum-like balance sheet accompanied by little or no explanation seems to be preferred. In some cases it is even worse than that; the Semi-annual Statement of Operations of the American Locomotive Company, June 30, 1932, contains no balance sheet whatsoever, although the stockholder is assured that his company is in a "strong financial position" after a deficit of $1,971,833.08 is shown for the preceeding six months (see page 56).

For several years General Foods Corporation and Subsidiary Companies have published a very scant Profit and Loss Statement (see page 57) which is not accompanied by a balance sheet.

The treatment of "goodwill" on statements has a marked

effect on the capital of the company. Suppose a company with a balance sheet as follows:

THE X COMPANY

BALANCE SHEET
December 31, 1932

Current Assets	$500,000.00	Current Liabilities	$300,000.00
Fixed Assets (net)	700,000.00	Fixed Liabilities	200,000.00
Deficit	150,000.00	Capital Stock	850,000.00
Total Assets	$1,350,000.00	Total Liabilities and Capital	$1,350,000.00

This statement, because of the large deficit, will make an unfavorable impression on stockholders so the directors decide to value goodwill at $300,000.00 and it is written on the books accordingly. (Of course, they may be conscientious and, rather than merely write on goodwill, charge advertising and other current expenses to such an account.) The statement will then make a much more favorable impression on the average stockholder for it will show a surplus of $150,000.00 rather than a deficit.

THE X COMPANY

BALANCE SHEET
December 31, 1932

Current Assets	$500,000.00	Current Liabilities	$300,000.00
Fixed Assets (net)	700,000.00	Fixed Liabilities	200,000.00
Goodwill	300,000.00	Capital Stock	850,000.00
		Surplus	150,000.00
Total Assets	$1,500,000.00	Total Liabilities and Capital	$1,500,000.00

The Consolidated Balance Sheet of the Chrysler Corporation and Subsidiaries, September 30, 1929, shows "Good Will-----$25,000,000.00"--more than ten per cent. of total assets. Julius Kayser & Co. and Subsidiary Companies, Consolidated Balance Sheet, June 30, 1930, shows patents, trade-marks, and goodwill at a figure

of $5,644,000.00--almost eighty per cent. of their total earned surplus of $7,387,560.91 and one-fourth of their total assets of $22,581,980.55. The propriety of these figures is determined by whether or not they arose from actual capital outlay. If they are the result of capital expenditures, they are proper; if they represent only a book entry or operating expenses of prior periods, there is over-capitalization and stock-watering.*

Writing off goodwill and other intangible assets, such as patents, copy-rights, and trade-marks, is a favorite method of creating secret reserves. Attention is called to the Balance Sheet of Brown Shoe Company, Inc. as of October 31, 1931 (see pages 41-2) with respect to the valuation placed on lasts, prepaid insurance and licenses, and goodwill and patent rights. Even the scrap value of the lasts of a company of this type is far in excess of one dollar. Any under-valuation of assets must reflect in a similar under-statement of the surplus of the company.

General Baking Company, in its annual report as of December 26, 1931, shows "'Bond Bread,' Other Trade Names, Trade-Marks, Copyrights and Goodwill-----$1.00." In the accompanying Statement of Profit and Loss and Earned Surplus--"Proportion of goodwill written off, together with disbursements incident to capital readjustment-----$2,345,696.49" is a charge to earned surplus. Further, in the Statement of Capital Surplus there is a charge, "Goodwill written off, less amount charged to earned surplus-----$4,293,697.23."

Liggett and Myers Tobacco Company, in its Balance Sheet

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*Applies only to operating statements. Capitalized excess profits may properly be shown as goodwill for purposes of sale.

B R O W N S H O E C O M P A N Y, I N C.

A N N U A L R E P O R T

OCTOBER 31st, 1931

CONSOLIDATED BALANCE SHEET

C O N S O L I D A T E D

B R O W N S H O E

and Subsid-
At The Close of Business

ASSETS

CURRENT:			
Cash		$1,148,798.76	
Customers' Accounts Receivable, After Providing for Doubtful Accounts		6,325,306.20	
Prepaid Purchases		19,398.47	
Inventories: At the Lower of Cost or Market Prices:			
Finished Merchandise	$3,159,268.40		
In Process, Raw Material, and Supplies	2,527,389.09	5,686,657.49	$13,180,160.92
OTHER ASSETS:			
Sundry Securities		$ 71,433.91	
Personal Notes (Secured) and Sundry Accounts, Etc.		742,708.31	814,142.22
PERMANENT--At Book Values:			
Land and Buildings	$2,163,362.29		
Less Allowance for Depreciation	577,754.36	$1,585,607.93	
Machinery	$2,816,923.74		
Less Allowance for Depreciation	1,618,226.48	1,198,697.26	2,784,305.19
LASTS			1.00
PREPAID INSURANCE, LICENSES, ETC.			1.00
TRADE NAME, GOOD WILL, PATENT RIGHTS, ETC.			1.00
			$16,778,611.33

B A L A N C E S H E E T

C O M P A N Y, I N C.

iary Companies
---------October 31, 1931

LIABILITIES

CURRENT:				
Notes Payable			NONE	
Accounts Payable:				
Purchases, Expenses, Etc.		$ 667,329.97		
Employees' Savings Accounts		223,703.73	$ 891,033.70	
Accrued General Taxes			59,200.00	
Reserve for Estimated 1931 Income Taxes			229,000.00	$ 1,179,233.70
CAPITAL:				
Preferred Stock--7% Cumulative:				
Authorized		$4,537,500.00		
Less:				
Retired and Cancelled	$962,500.00			
Held in Treasury	40,800.00	1,003,300.00	$ 3,534,200.00	
COMMON STOCK AND SURPLUS:				
Common Stock:				
Authorized, 500,000 shares without par value--Issued, 252,000 shares		$3,433,635.54		
Earned Surplus		8,631,542.09	12,065,177.63	15,599,377.63
				$16,778,611.33

for the year ended December 31, 1928, shows "Brands, Trade-Marks, etc.,-----$40,709,711.21" while in a similar report for the year ended December 31, 1929, "Good Will" replaces "Etc." and the value shown for the account, "Brands, Trade-Marks, and Good Will" is one dollar. The Income Account shows this difference as a deduction from surplus.

The Consolidated Balance Sheet of Eastman Kodak Co., and Subsidiary Companies as at December 26, 1931 (see pages 44-5) shows "Good Will and Patents of Parent Company and Subsidiaries -----Nil." Perhaps the Surplus account would be larger if this account were shown at actual cost less proper amortization.

Less information is to be found concerning depreciation, depletion, and amortization, and their corresponding credits than any other class of items on published reports. Not only the amount of these reserves and of the current credit made to them should be shown but also the method of determining the amounts must be explained if the reader is to get any reliable facts from the report. Practically no statements explain the method used in determining depreciation or how the reserve has been accumulated. Depreciation, at the best, is approximate and it is only fair that the method of its determination be explained in full. A great number of these reports give assets at net rather than at cost less depreciation.

The deduction from assets for depreciation, depletion, etc. has a direct effect on the surplus of the company. If depreciation is over-stated, surplus must be under-stated by a like amount and vice-versa. Suppose a correct depreciation reserve of

29TH ANNUAL REPORT

E A S T M A N K O D A K C O M P A N Y

1931

Consolidated Balance Sheet
December 26, 1931

E A S T M A N   K O D A K   C O M P A N Y

C O N S O L I D A T E D   B A L A N C E

ASSETS

CURRENT ASSETS:		
Cash in bank and on hand	$ 16,321,217.01	
Marketable bonds and stocks (at market value Dec. 26, 1931)	10,789,568.20	
Accounts and bills receivable (less reserve)	15,951,456.69	
Inventories of raw materials, supplies, work in process and finished product at cost or market, whichever is lower	33,541,840.18	$ 76,604,082.08
INVESTMENTS AND ADVANCES:		
Affiliated Companies	$ 1,732,420.21	
Other	3,040,306.25	4,772,726.46
LAND, BUILDINGS, PLANT AND MACHINERY AT COST	$106,223,742.51	
Less: Reserve for depreciation	36,312,683.05	69,911,059.46
GOODWILL AND PATENTS OF PARENT COMPANY AND SUBSIDIARIES		Nil
DEFERRED CHARGES TO FUTURE OPERATIONS:		
Unexpired insurance, Etc.		887,484.24
		$152,175,352.24

A N D S U B S I D I A R Y C O M P A N I E S

S H E E T, D E C E M B E R 2 6, 1 9 3 1

LIABILITIES

CURRENT LIABILITIES:			
Accounts payable, including provision for Federal taxes		$ 6,644,683.94	
Notes Payable		4,000,000.00	
Dividends payable:			
Preferred--No. 118 of 1½%	$92,485.50		
Common--No. 118 of $1.25 per share	2,819,956.25		
Extra--No. 120 of $.75 per share	1,691,973.75	4,604,415.50	$ 15,249,099.44
GENERAL AND CONTINGENT RESERVES			3,499,029.49
CAPITAL STOCK AND PAID IN SURPLUS:			
6% Cumulative Preferred Stock-- $100 par value:			
Authorized--100,000 shares			
Issued-- 61,657 shares		$ 6,165,700.00	
Common Stock--No par value:			
Authorized--2,500,000 shares			
Issued-- 2,263,150 shares			
Less in Treas. 7,185 shares			
2,255,965 shares			
at stated value of $10 per share	$22,559,650.00		
Paid-in surplus	28,782,600.00	51,342,250.00	57,507,950.00
SURPLUS, as per annexed statement			75,919,273.31
			$152,175,352.24

$240,000.00 for a company whose balance sheet is as follows:

The Blank Company

BALANCE SHEET
December 31, 1932

ASSETS		
Current Assets		$500,000.00
Fixed Assets	$850,000.00	
Less--Reserve for Depreciation	600,000.00	250,000.00
Total Assets		$750,000.00
LIABILITIES		
Current Liabilities	$150,000.00	
Fixed Liabilities	50,000.00	$200,000.00
CAPITAL		
Capital Stock	$400,000.00	
Surplus	150,000.00	550,000.00
Total Liabilities and Capital		$750,000.00

Since the reserve is over-stated by $360,000.00 it is obvious that surplus is under-stated by that amount and if the balance sheet were correct, it would show $510,000.00. A secret reserve has been established by the incorrect credit to the reserve account.

In the same case, suppose a balance sheet showing "Reserve for Depreciation" at $100,000.00. Surplus would then be $650,000.00 and, unless the method of determining the figure was explained, no one reading the statement would be the wiser.

Eastman Kodak Company does not show the amount deducted for bad debts in 1931 although such a deduction is indicated on the Balance Sheet (see pages 44-5). Union Tank Car Company, June 30, 1930 (see page 47) follows the same proce~~e~~dure with respect to depreciation on fixed assets and fails to show any provision for doubtful accounts. Can it be that the total

U N I O N   T A N K   C A R   C O M P A N Y

B A L A N C E   S H E E T
(Consolidated)
June 30, 1930

ASSETS

CURRENT:		
Cash	$ 8,253,191.40	
*Securities	3,920,822.71	
Accounts Receivable	1,556,353.78	
*Materials and Supplies	471,214.18	
Accrued Income and Deferred Charges	74,468.62	$14,276,050.69
FIXED:		
Tank Car Equipment (Less Depreciation)	$33,874,950.82	
Property, Plant and Equipment (Less Depreciation)	1,764,359.62	35,639,310.44
UNAMORTIZED DEBT (Discount)		107,007.72
		$50,022,368.85

LIABILITIES, CAPITAL STOCK AND SURPLUS

CURRENT:		
Accounts Payable	$ 1,477,944.63	
Accrued Interest	102,375.00	$ 1,580,319.63
RESERVES:		
Federal Income Taxes	$ 378,401.65	
Miscellaneous	405,205.12	783,606.77
4½% EQUIPMENT TRUST CERTIFICATES		9,100,000.00
CAPITAL STOCK--NO PAR VALUE:		
(Authorized 3,000,000 Shares)-- Outstanding 1,254,048 Shares		31,351,200.00
SURPLUS		7,207,242.45
		$50,022,368.85

*At Cost or Market whichever is lower.

of $1,566,353.78 of accounts receivable are good and expected to be collected in full? Similarly, Liggett & Myers Tobacco Company, in its balance sheet for the year ended December 31, 1931, shows "Accounts Receivable-----$10,993,027.09" without provision for bad debts!

Although the generally approved method of valuing inventories is "cost or market (replacement market, not selling price), whichever is lower," the valuation may be made on any convenient basis to "adjust" the condition of the company. Any mis-statement in value effects both surplus and profits correspondingly. Some instances of variation in inventory valuation of several corporations are noted. Brown Shoe Company (see pages 44-5) states that inventories are valued at the lower of cost or market prices. Tide Water Oil Company and Subsidiaries, Consolidated Balance Sheet, June 30, 1932, shows "Crude Oil and Products (At lower than Market)-----$9,311,454.82." The reader is left to guess the cost of this item or to determine how much lower than market is expressed in the figure given. The consolidated Balance Sheet, September 30, 1930, of the Pan-Handle Producing and Refining Company and Subsidiary Companies shows "Oil (At Market Value)-----$237,386.02." Can it be that a profit has been taken on all the finished product on hand in this company? This practice cannot be worse than failing to indicate the method of valuation of inventories as is done in the Statement of Assets and Liabilities, December 31, 1930, of the Pittsburgh Plate Glass Company (see page 49). No reader can determine the method used in arriving at this valuation.

P I T T S B U R G H   P L A T E   G L A S S   C O M P A N Y

STATEMENT OF ASSETS AND LIABILITIES
DECEMBER 31, 1930

			Assets	Liabilities
ASSETS:				
Investment			$62,860,338.06	
Merchandise		$10,312,127.26		
Material and Working Accounts		6,578,401.79		
Bills and Accounts Receivable		9,559,835.71		
Federal Government and Other Securities		8,026,830.23		
Cash		1,988,311.70		
Quick Assets			36,465,506.69	
Treasury Stock			279,284.50	
LIABILITIES:				
Capital Stock Authorized		$65,000,000.00		
Less--Unissued Capital Stock		10,836,900.00		$54,163,100.00
Sundry Credits:				
Bills Payable		NONE		
Accounts Payable--Current		$ 3,003,031.70		3,003,031.70
General Insurance Reserve				1,582,724.97
Reserve for Inventory Deflation, Obsolescence and Other Contingencies				2,058,624.07
Reserve for Estimated Federal Income Taxes Payable in 1931				450,000.00
PROFIT AND LOSS:				
Surplus January 1, 1930		$37,937,218.39		
Earnings Year 1930		9,121,841.56		
		$47,059,059.95		
Less:				
Depreciation, Obsolescence and Depletion	$3,928,303.09			
Cash Dividends	4,322,916.00			
Federal Income Taxes paid year 1930 in excess of Reserve	10,192.35			
Reserve for Estimated Federal Income Taxes Payable in 1931	450,000.00	8,711,411.44		
Balance in Surplus December 31, 1930				38,347,648.51
			$99,605,129.25	$99,605,129.25

The comments made on the valuation of inventories apply with equal force to other assets in that any incorrect valuation of an asset has the same effect on the capital section of the balance sheet. Very little uniformity is found in the methods of valuing assets and the method is seldom explained. Eastman Kodak (see pages 44-5) values marketable securities and stocks at their market value at the time of preparing the balance sheet; investments and advances are divided as to "Affiliated Companies" and "Others" but the amount is not explained and it is impossible to determine, from the statement, what is meant by "Others." The Tide Water Oil Company and Subsidiaries, Consolidated Balance Sheet, June 30, 1932, shows "Securities in Escrow--at cost (market value $361,693.75)-----$594,068.36." "Other Investments and Receivables" and "Investments in Affiliated Companies" are shown at cost while market value is not shown. Is the former over-valued? Liggett & Myers Tobacco Company, Balance Sheet for the year ended December 31, 1931, shows no valuation methods except for inventories which are at cost. The Consolidated Balance Sheet of Missouri--Kansas Pipe Line Company and Subsidiary Companies, March 31, 1930, shows an asset account, "Plant, Property, Contracts, Leaseholds, Etc. (including gas purchase and sales contracts at a valuation of $1,106,250.00 of which $880,000.00 was determined by independent engineers and $226,250.00 by the Board of Directors)-----$6,265,839.37." It is not explained why the Board of Directors determined a "write-up" of $226,250.00 but not all companies would go so far as to

explain that part of the figure shown was an "arbitrary valuation" or that any of the amount given did not represent actual cost.

The practice of showing several items in the same account has met with general usage by many companies--a very unfortunate condition. Brown Shoe Company, October, 31, 1931 (see pages 41-2) combines the inventories of goods in process, raw materials, and supplies into one account while Eastman Kodak, December 26, 1931 (see pages 44-5) combines inventories of raw materials, work in process, and finished goods. Land, buildings, plant, and machinery is also combined in the latter. The American Chicle Company, Comparative Consolidated Balance Sheet, June 30, 1931, groups investments with Notes Receivable and consolidates land, buildings, and machinery into one account. Chrysler Corporation and Subsidiaries, Comparative Consolidated Balance Sheet, September 30, 1929, groups "Land, Buildings, Machinery, Equipment, Dies, etc." and all inventories are in one amount.

When all inventories are found in one account it is impossible to determine whether they consist principally of finished goods or whether the stock of goods ready for sale is limited while supplies are far in excess of current needs. Land, which does not ordinarily depreciate, should not be included with depreciating assets for it is then impossible to determine the depreciative amount of the figure given. Assets with different depreciation rates must be separated if the reader is to secure the desired information from a statement. He can

neither determine the amount represented by each asset, the adequacy of the depreciation reserve on the balance sheet, or the propriety of the charge to current operations. It would require little more effort or space on the statement to show these items separately and the report would be much more readable.

Many evils may be covered by careful selection of names for accounts shown on reports. A company showing "Government Bonds and Other Securities" in its assets at $350,000.00 may own $5,000.00 in government bonds and $345,000.00 in stocks of some unknown company which may be virtually bankrupt. Many vague accounts may be found in published balance sheets and they mean absolutely nothing unless their content can be analyzed. This is impossible for the "outsider" unless an explanation is attached. Pittsburgh Plate Glass Company, December 31, 1930 (see page 49) shows such accounts as "Investment," "Material and Working Accounts," and "Federal Government and Other Securities" in its assets. Eastman Kodak, December 26, 1931 (see pages 44-5), shows "Other" under "Investments and Advances." The asset side of the balance sheet of Liggett & Myers Tobacco Company (see page 53) is an excellent illustration of scantiness and vagueness. With such asset accounts as these, the most experienced analist can determine little, if anything, of the true financial condition of the company being studied.

Nor is this vagueness of terminology limited on the balance sheet to assets. Tide Water Oil Company, Consolidated Balance Sheet, June 30, 1931, shows "Reserves for Contingencies

LIGGETT & MYERS TOBACCO COMPANY

BALANCE SHEET FOR YEAR ENDED DECEMBER 31, 1931

ASSETS

Real Estate, Machinery and Fixtures		$ 23,988,006.68
Brands, Trade-Marks and Good Will		1.00
Current:		
Leaf Tobacco, Manufactured Stock and Operating Supplies, at cost	$90,044,681.51	
Stock in Subsidiary Companies	492,583.70	
Securities	4,476,164.08	
Accounts Receivable	10,993,027.09	
Accounts Receivable in Allied Companies	11,995.41	
Cash	27,075,001.16	
Preferred Stocks	2,480,785.00	
United States, State and Municipal Bonds	20,980,450.40	156,554,688.35
Total Assets		$180,542,696.03

-----$2,167,210.74." Eastman Kodak, December 26, 1931, (see pages 44-5), shows "General and Contingent Reserves-----$3,499,029.49." It is impossible to determine whether these accounts represent reserves for actual anticipated losses or are used in whole, or in part, as a means of setting aside available surplus to take care of lean years.

Many balance sheets are made unnecessarily hard to read by the classification of accounts used. In order that comparisons may be made easily and ratios may be readily determined, some logical and uniform system should be followed. On some balance sheets, securities are to be found under current assets while others place such accounts under a separate heading such as "Investments." No uniformity is found with respect to reserve accounts; some showing them as liabilities rather than as deductions from their corresponding asset

accounts.. Such a practice makes it necessary for the reader to make calculations that should be made on the statement itself. Depreciation must be deducted from assets against which it applies before a comparison can be made between fixed assets and fixed liabilities. If investments in affiliated companies are included with current assets, the amount must be deducted before an accurate current ratio can be determined. This could be eliminated if more regard were given to classifications on the balance sheet.

PROFIT AND LOSS.--In recent years as much importance has come to be attached to the profit and loss statement as to the balance sheet. No complete analysis can be made of a report without both and the analyst has found that many significant figures and comparisons can be secured from a complete profit and loss statement. There he expects to find charges for the current credits to operating reserves as well as the income and other expense items that determine profit or loss. General Foods Corporations and American Locomotive Company have gone so far as to publish a profit and loss statement with no balance sheet. This is very undesirable, however, for the balance sheet must be used in conjunction with the profit and loss statement if the latter is to be properly interpreted. Pittsburgh Plate Glass Company (see page 49) proposes to publish a profit and loss statement in its report but the only actual "Profit and Loss" accountsgivenare "Earnings Year 1930-----$9,121,841.56" and "Depreciation, Obsolescence and Depletion -----$3,928,303.09" which is incorrectly deducted from earnings

plus surplus rather than from net earnings for the year.

If depreciation is over-charged, profits will be smaller by an equal amount while an under-charge to depreciation over-states profits to an amount equal to the under-statement. Suppose a case where net profits, before allowing for depreciation, are $600,000.00 while depreciation is correctly determined as $200,000.00. Net profits for the period would then become $400,000.00 but if depreciation was stated as $300,000.00, net profit would be $300,000.00--an under-stated profit by $100,000.00. If depreciation was erroneously determined to be $100,000.00, net profits would show $500,000.00--an over-statement of $200,000.00. Since net profit (or loss) is closed directly to surplus account, any incorrect determination of profit will effect surplus in the same manner and to an equal extent; if profits are over-stated by $200,000.00, surplus will be over-stated by $200,000.00, aside from other inconsistencies that may affect it.

For a profit and loss statement to be of any great value to a reader, it must show, at a minimum; gross sales, net sales, cost of goods sold (how determined), operating and selling expenses, depreciation charges, financial income, and financial expenses. Practically no published statements are complete in all of these details and many, in their last analysis, show nothing. American Locomotive Company and Subsidiaries, Consolidated Income Account (see page 56) shows only "Net Loss from Operations" and "Depreciation on Plant and Equipment." General Foods Corporation and Subsidiary Companies, Profit and Loss Statement, year ending

C O N S O L I D A T E D I N C O M E A N D S U R P L U S

A C C O U N T S

AMERICAN LOCOMOTIVE COMPANY AND SUBSIDIARIES

For the six months ended
JUNE 30, 1932

CONSOLIDATED INCOME ACCOUNT

NET LOSS FROM OPERATIONS, after deducting manufacturing, maintenance and administrative expenses	$ 1,225,220.65
DEPRECIATION ON PLANTS AND EQUIPMENT	746,612.43
DEFICIT FOR THE SIX MONTHS	$ 1,971,833.08

CONSOLIDATED SURPLUS ACCOUNT

SURPLUS, December 31, 1931		$20,661,195.96
DEFICIT FOR THE SIX MONTHS ENDED June 30, 1932		1,971,833.08
		$18,689,362.88
DIVIDENDS--Preferred Stock		1,256,493.00
SURPLUS, June 30, 1932		$17,432,869.88
Earned Surplus	$16,656,161.81	
Capital Surplus	776,708.07	

G E N E R A L   F O O D S   C O R P O R A T I O N
and Subsidiary Companies

PROFIT AND LOSS STATEMENT
Fourth Quarter Ending December 31, 1931

Gross Profits from Operations	$12,839,421
Selling, Distributing, Administrative, and General Expenses and Other Charges	8,743,019
	$ 4,096,402
Provision for Depreciation	632,537
Balance	$ 3,463,865
Add Miscellaneous Income	251,167
Total Income	$ 3,715,032
Provision for Income Taxes (Credit to correct reserve)	30,884
Net Profits	$ 3,745,916

Year Ending December 31, 1931

Gross Profits from Operations	$58,998,990
Selling, Distributing, Administrative, and General Expenses and Other Charges	37,373,519
	$21,625,471
Provision for Depreciation	2,320,865
Balance	$19,304,606
Add Miscellaneous Income	850,353
	$20,154,959
Provision for Income Taxes	2,001,240
	*$18,153,719

*Equals $3.44 per share on 5,275,667 shares of no par common stock outstanding December 31, 1931. This is comparable with $19,085,595 for 1930 equivalent to $3.63 per share on 5,256,843 shares outstanding December 31, 1930.

December 31, 1931 (see page 57), groups "Selling, Distributing, Administrative, and General Expenses and Other Charges," with very little other information being shown. In the entire report (no balance sheet), they do not bother with showing "cents" at all--"dollars" is near enough! And the statement becomes entirely unreadable when it is noted that, to arrive at "Net Profit" for the period (quarter ending December 31, 1931), an addition of "Provision for Income Taxes (Credit to correct reserve)-----$30,884" is made to "Total Income." Just what this means, no "reader" can possibly determine. In the statement for the year ending December 31, 1931, an item with the same name is deducted. The amount shown as "Net Profits" in the former is proper only if this provision for Income Taxes was included in some preceeding item. At the best, the two statements are not consistent and much is left to the imagination of the person reading the statement. Can he be expected to guess correctly in all instances?

Brown Shoe Company, Inc. and Subsidiary Companies, Statement of consolidated surplus for the year ended October 31, 1931 shows "Cost of Material, Labor, Manufacturing Expense, and Selling, Administrative and General Expense, including Depreciation, Interest Charges, and Bad Debts" as a deduction from net sales.

The Income Statement of the Union Tank Car Company is given as an illustration of the type of profit and loss statement submitted to the stockholder and investor. It is not an exception but is the rule! It will be noted that the first

UNION TANK CAR COMPANY

INCOME STATEMENT
(consolidated)

Six Months Ended June 30, 1930

Profit from Operations (After Depreciation)	$1,388,178.82	
Other Income	240,937.42	$1,629,116.24
Interest on Equipment Trust Certificates and Other Deductions	$ 230,505.81	
Federal Income Taxes, estimated	158,936.39	389,442.20
Net Income, Six Months ended June 30, 1930		$1,239,674.04
Surplus, January 1, 1930		6,970,806.81
		$8,210,480.85
Dividends Paid		1,003,238.40
Surplus, June 30, 1930		$7,207,242.45

account is "Profit from Operations (After Depreciation)" and that no basic figures are given. Little more is known after the statement is studied than before.

Eastman Kodak Company and Subsidiary Companies, Consolidated Statement of Profit and Loss and Surplus for the Year Ending December 26, 1931, shows only net income, "Other Income," depreciation charge, "Other Charges (net)," provision for income taxes, and a deduction from net profit, "Excess of cost over tangible assets at acquisition of subsidiary companies wholly acquired during the year-----$3,717,074.22." Does not this charge represent purchased goodwill rather than a charge against net profit for the period? The amount paid for subsidiaries must have been represented by value! Is there not a secret reserve created?

Tide Water Oil Company and Subsidiaries, Consolidated

Surplus Account for the Six Months Ended June 30, 1932, has a charge to surplus: "Revaluation of assets and write-off of unrecoverable and intangible items approved by the Board of Directors May 5, 1932-----$17,813,325.00." No explanation is made as to the amount representing asset revaluation or what other items were affected although a footnote to the balance sheet states that effect is given to the "revaluation and write-off" on that statement.

In an editorial appearing in The Magazine of Wall Street, several interesting incidents concerning mis-stated earnings are reported: B. F. Goodrich Co., 1926, transferred $5,000,000.00 from a reserve account to show total income of $8,040,000.00 before bond interest was deducted; the same year U. S. Rubber Company transferred $5,000,000.00 from plantation operations to profit and reported earnings of $4.50 per share whereas "common stock lacked earning power"; Baldwin Locomotive, 1926, credited profits with $7,300,000.00 which was received from foreign governments and covered five years operations; Manhattan Electrical Supply Company, 1926, made a current credit amounting to $12.00 per share extra profit from the sale of its battery business.[1]

As long as American Corporations are allowed to publish such reports, without protest, as are generally received by stockholders and the public, there will remain a condition of "ignorance of ownership" and the investor cannot hope to

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1. April 9, 1927--Alice in Financial Wonderland, p. 1125-6.

obtain an accurate knowledge of the business using his capital. He must still guess to the best of his ability and hope that all is well while relying on the reputation of the company in which his money is invested.

CONCLUSION

ATTEMPTED REMEDIES.--So little has actually been accomplished by virtue of remedies that have been attempted, as compared with the extent of the problem of ownership without either control or knowledge and its corrollary, uninformative reports, that they deserve little consideration in the future. They have helped, no doubt, in some cases and may have exerted an influence in keeping the general condition from becoming worse than is found at present but, by their evident lack of solution, they are proven to be entirely inadequate to cope with the situation and little time need be spent with them. However, it seems that several of the more important and more widely recognized attempts to "give the stockholder a chance" should be mentioned and criticized briefly.

Cumulative voting has perhaps done more to bring representation and information to the minority stockholder than any other one expedient found in American finance. By its use, the minority stockholder is able to secure representation on the board of directors of his corporation provided his holdings are significant.

By "cumulative voting" is meant the authority, not to cast only one vote for each share of stock held as is the case without the cumulative provision, but to cast as many votes as the product of the number of shares held multiplied by the number of directors to be elected. Thus, if stockholder A owns 100 voting shares and there are ten directors to be elected, A has

1000 votes which may all be voted for one director or may be apportioned between two or more directors as A sees fit. If there are not more than 1000 shares of voting stock outstanding, A is assured of securing the election of one director if his votes are concentrated to that end.

With representation on the board of directors, minority interests have a means of obtaining information even though their representative is out-numbered and may be over-ruled at meetings of the board. It is an advantage to be represented and have a source of information even though no great degree of control is possible. There is someone on the inside to supervise the interests of the minority.

Cumulative voting has fallen short in several particulars. It is not a right of the stockholder unless it is so provided by state statute, charter, or by-laws of the corporation. This makes it operative in comparatively few cases since states have not generally made the provision compulsory and few corporations have voluntarily endowed their stockholders with this extra privilege. Furthermore, it is of no value to a stockholder who does not hold a percentage of the stock large enough to elect a director--he seldom personally votes his stock in any case for proxies are often more convenient.

Various classes of stock have been given the right to elect specified numbers on the board of directors. Thus, if there are three classes of stock issued and outstanding, each class may be permitted to elect, let us say, three directors. Although "Class C" stock may represent only ten per cent. of total

stock outstanding, Class C stockholders are represented equally with Class A and Class B stock on the board. But this still gives no advantage to the small stockholder and the "would-be investor" is entirely without means of obtaining information about the company in which he is interested.

Voting trusts, whereby stock is concentrated in the hands of a trustee to be voted, have been used as a means of obtaining representation and control. Voting trusts have not only failed to secure relief but have proven to be a tendency in the opposite direction in many instances. They have come into such general ill-repute that, "The highest court in Illinois condemned them unqualifiedly as illegal arrangements."[1]

PROPOSED REMEDIES.--As a means of securing adequate reports, it has become customary in England for the auditor of a company to be elected by the stockholders. The adoption of this practice in America would undoubtedly meet with the approval of minority stockholders and, with several additions to the English practice, would serve a dire need. The stockholder would then be furnished with reliable information and enough facts could be demanded so that published reports would be true financial statements instead of blotter-like pamphlets or advertisements of the company. A provision would, of course, be necessary whereby the election of the auditor by the stockholders would be compulsory by statute rather than optional to the corporation if any great benefit is to be derived from such a practice. Corporations have reached the place where they must be governed by requirement rather than by

1. Saliers, Earl A.--Accountant's Handbook, p. 195.

their option as has too often been the unfortunate condition in the past.

To be of any consequence, such a practice would have to incorporate some definite responsibility on the auditor in question. All auditors, although they may be public accountants and be appointed to serve the stockholders, are not of the highest moral character. They might be influenced by the management of the company under audit to submit reports for "inside interests" or to neglect their duty of thorough examination. To insure the proper work of a stockholders' auditor, it would be necessary to bring some force to bear on him. This might be done by making it a felony for any auditor to make a false or misleading report and to bar him from practice thereafter. Unless some such provision were made and enforced, little weight could be attached to the reports of the auditor even though he were elected by the stockholders, Any management, with the support of dishonest stockholders could, in many cases, influence the election of incompetent and untrustworthy auditors who could be controlled by the management. There would arise a situation of "dummy" auditors which would be no better if as good as the present system.

Another important provision must be added to the English practice if it is to be complete. "The British practice as to independent audit is confined entirely to the balance sheet. . . . There is in England no independent audit of the income account."[2] Any audit must, to be complete, be a "detailed audit" and must

2. Ripley, William Z.--Wall Street and Main Street, p. 142.

include the profit and loss statement as well as the balance sheet. Comment is made in section IV of this study (p. 54-60) on the importance of an adequate profit and loss statement to accompany a balance sheet. To be adequate, it must be subject to the same scrutiny and detail as the balance sheet.

It is seen from the above that any provision of this kind would require federal supervision for state statutes could not be expected to provide uniform treatment under their present system of competition for the right to grant corporation charters. Such provision would not be passed unanimously by the several states nor would the same degree of control be provided in the states giving it favorable consideration. There would only be presented another means for encouraging "charter mongering" among the states practicing this art.

A "Uniform Corporations Act," similar to the present Uniform Sales Act or the Uniform Negotiable Instruments Act, could be so drawn as to correct most, if not all, of the present corporate abuses but it would meet with the same trouble as have the two acts mentioned--it would not be immediately passed by all the states. Those states not passing such an act would be given a marked advantage over states in which it was passed and, with the present system, there would be little incentive for its favorable consideration by many states. The right to grant charters has proven far too profitable to such states as Delaware and New Jersey for them to be favorably impressed by any act that would place them on an equal basis with other states in the competitive field of granting charters to new corporations.

Only by some drastic federal action could such an act secure serious consideration in these states.

Many provisions may be pointed out for inclusion in such an act and means might be provided whereby states would be almost compelled to adopt the act. These provisions and the means of compelling their adoption would be practically identical with those necessary under a requirement for providing federal grants of corporation charters and will be discussed in that connection.

The only complete and efficient way of providing a workable solution to the many problems connected with corporate organization and control seems to be through federal statutes. To be sure, there will be complaints from states when the right to grant charters is removed from them and there is the question of constitutionality but several methods may be suggested to overcome this problem.

> "It has at various times been suggested that congress, without violating the United States Constitution, can force federal incorporation through any one or all of the following methods:
>
> "(1) By excluding from the channels of interstate commerce the articles manufactured or otherwise produced by state corporations.
>
> "(2) By prohibiting all corporations not chartered by congress from engaging in interstate commerce.
>
> "(3) By laying a prohibitive tax upon the interstate business transacted by state-chartered corporations.
>
> "(4) By denying the use of the mails to state corporations that engage in interstate commerce."[3]

Any one of these methods would serve the desired purpose for few corporations which do not engage in interstate commerce are

3. Stockder, Archibald H.--Business Ownership Organization, p. 456.

large enough to require drastic methods of control. They are, for the most part, closely held and all the stockholders are on the "inside." Chartering rights would still remain with individual states but corporations operating under state charters would, of necessity, be small for they could not transact business outside the parent state. This would keep the federal government from being bothered with great numbers of small corporations as would be the case if all corporations were required to obtain federal charters. Also, there would remain no advantage in maintaining lax charter laws on the state statutes since only state corporations could be chartered and we would see much better laws on the state records. On the other hand, such a restriction would be placed on the majority of large corporations acting under state statutes that they would be practically compelled to procure federal charters.

The first consideration of any future legislation concerning corporations should be provision for protection of minority interests. There should be protection against the possibility of the issue of stock at a price below true value. This would change the present provision of requiring par value stock to be sold at not less than par and would consider actual value rather than the fiction of par value. Stock issues for property and services warrant a closer scrutiny than has been generally accorded such transactions.

Each charter, or the by-laws of every corporation, should specify the amount of fixed liabilities the company may incur and should provide for salaries of officers and executives

as well as state the proportion of earnings to be carried to surplus after dividends are declared and the maximum accumulated surplus to be held in the company.

Provision for determining depreciation and valuing intangible assets should be set forth in the by-laws. Allowance for the creation of reserves should be determined and explained and definite rules should be formulated in each charter for the acquisition and control of subsidiary companies.

Certificates of stock ownership should be required to contain a detailed description of the rights and liabilities attached to the holders of such stock. Anyone purchasing stock would be given constructive notice of his particular position with reference to the company and other stockholders upon the acquisition of stock.

The influence of the Interstate Commerce Commission on enterprises under its regulation indicates what can be accomplished by federal regulation of all large corporations. The authority of this agency might be extended to cover the acts of all corporations coming under federal control by virtue of this suggestion. There might be a new department created to be known by such a name as "The Corporation Commission" to inspect and regulate these companies or the Federal Trade Commission might be given that capacity. "Let the word go forth that the Federal Trade Commission is henceforward to address itself vigorously to the matter of intelligent corporate publicity, and, with the helpful agencies already at work, the thing is as good as done."[4]

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4. Ripley, William Z.--Stop, Look, Listen! Atlantic Monthly, September, 1926, p. 398.

Under whatever department this function should fall, its duties and responsibilities must be well-defined and active supervision must be provided.

Federal regulation of any kind must bring with it the use of uniform accounts by corporations under its supervision. Records must be kept as prescribed by the governing commission for its inspection and for preparation of reports required by the commission. But the mere use of these accounts and the preparation of statements to be presented to the commission from them is not enough. The stockholder and investor will be little better informed than before unless the published reports of the corporation are required to be identical with those presented to the commission. The real need is for informative published reports and provision for such, at least annually, is necessary under any adequate system of regulation. This might easily be included in the statutes and it would be well to do so.

With the stockholder and investor receiving reports which actually give information, their necessary interest and support will naturally follow. The information has always been desired but existing conditions have numbed this desire by so completely failing to satisfy it that the public stockholder has almost lost heart and his complaints are scarcely audible among the roars of "competitive reasons" by corporate managements. Once the stockholder finds that facts can be had and the interest of capital is whole-heartedly solicited, this interest will find expression. "Prosperity, not real but specious, may indeed be unduly protracted by artificial means, but in the end the truth is bound to prevail.

Nor can the truth work harm to those whose custom it is to work in daylight. It is the wrongdoer alone, delving in darkness and diligent in deviousness, who fears the strong tonic of publicity."[5]

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5. Ripley, William Z.--op. cit., p. 352-3.

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